DOW THEORY LETTERS INC.

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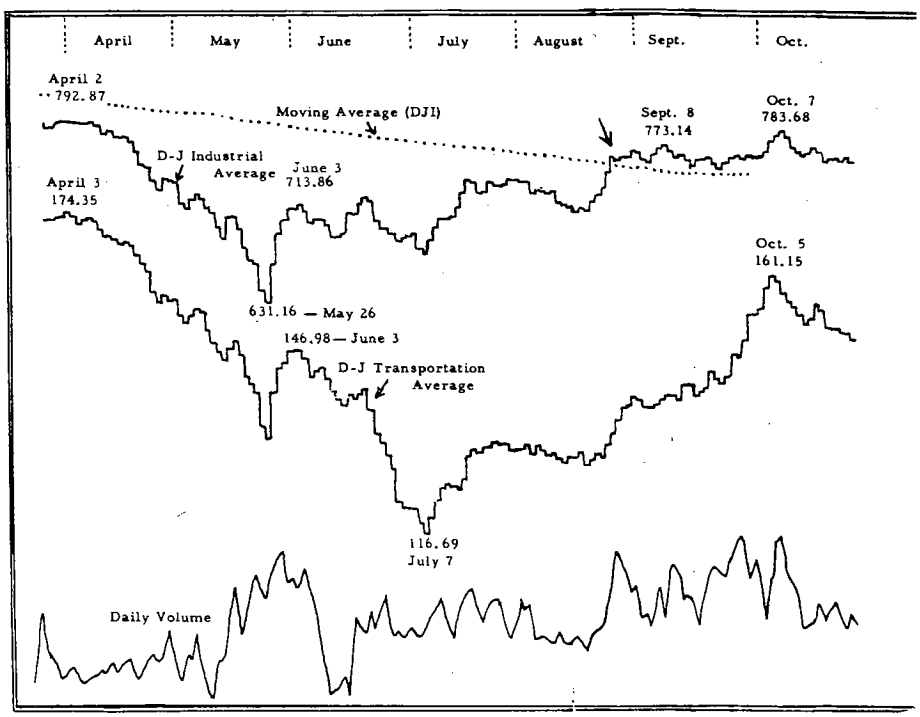
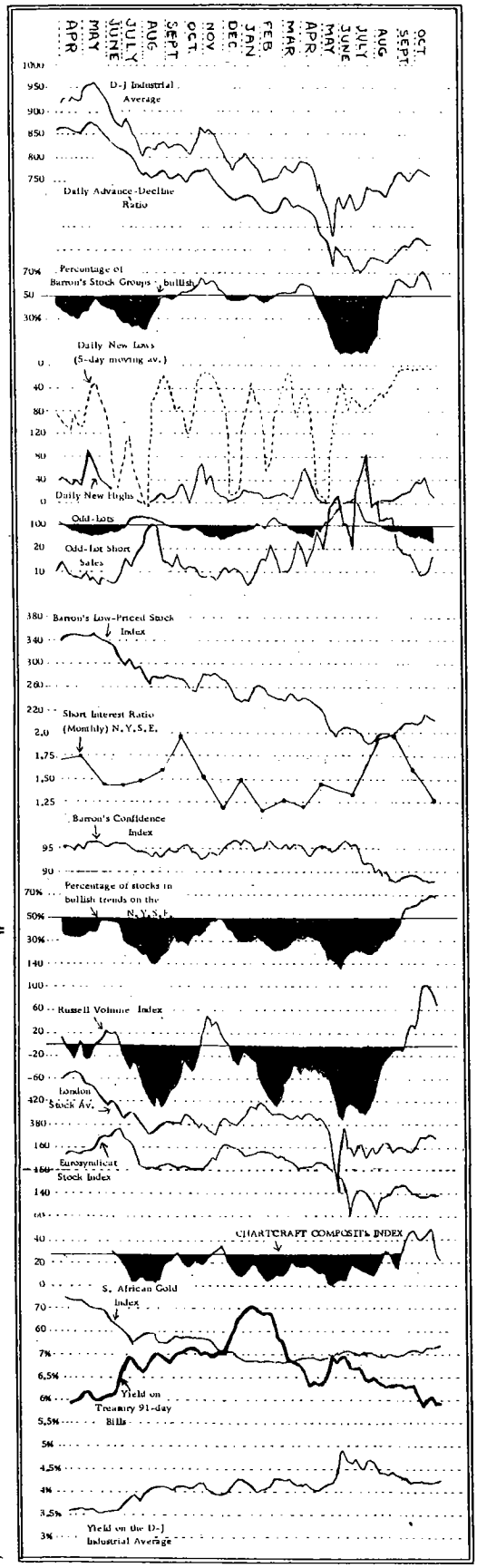
THE MARKET: Glance down and study the chart of the D-J Averages at the bottom of this page. I have drawn a little arrow at the August 24 closing of 759.58. That date marks the beginning of the sideways, huge-volume which has lasted to the present. And that date, to my mind, marks the point where the latest massive distributions in this primary bear market began.

Note the volume line accompanying the area which began on August 24. It is huge, having produced record volume above 80 million shares a week on two separate weeks. Yet the progress in the Dow Industrial Average since August 24 has been nil, and this suggests a giant churning area with top-grade industrial stocks passing from stronger hands to weaker hands.

I have no doubt that shrewd traders noted that the market was over-sold at the May 26 bottom. They also noted that the short-position was vulnerable. And it was those same traders who stepped in to produce another high-volume, speculative bear market rally. But by late-August the traders were ready to take their profits. And undoubtedly around that same date the public, the funds, the pension plans and the institutions were moving in on stocks that the traders were only too willing to swap for cash.

Ironically, it was the Government which gave the traders the market they needed to get rid of their shares. Under the "umbrella" of one of the biggest "bull" campaigns in recent history on the part of Government spokesmen, millions of stocks changed hands. In short, the Administration "made a market" for the traders who had picked up shares off the May bottom. Incidentally, I couldn't resist reprinting this little cartoon (Page 2), a cartoon which I feel well illustrates the bunk and nonsense which has been sifting down onto Wall Street from high places.





I have dwelt a great deal in recent Letters on the all-important but little-understood meaning of the primary trend of the market and the economy. If this was a bull market, Mr. Nixon's efforts at "game-planning" might have run this market through the roof. But in today's primary bear market, all the talk, hopes and aspirations of the Administration haven't been able to make much more than a sizable dent on Wall Street. Since late-August the bear market has chewed up and digested the new buyers the way a bear laps up honey. Since August 24, hundreds of millions of shares have been purchased and there have been eager sellers for every share. The net result — it's shown on the page 1 chart. The Dow Industrials, the 30 giant corporations whose value make up 25% of the value of the entire N.Y.S.E., have not really done anything at all on the upside.

"Gentlemen, to conclude our meeting, I would like you to chant after me—'inflation is easing and the economy will start turning upward . . .'"

* * * *

On the latest tabulations, the short interest in the 30 Dow stocks has dropped around 175,000 shares. I do not yet have the latest Dow short interest ratio from Bill Gordon in New York, but it should be well under the critical 1.0 level (this will be reported in the next mailing). Meanwhile, the 20-most active stocks index, after being plus for seven weeks, dropped to minus 10 on the week ending October 16, minus 22 on the week ending October 23. The N.Y.S.E. leadership is once again on the downside.

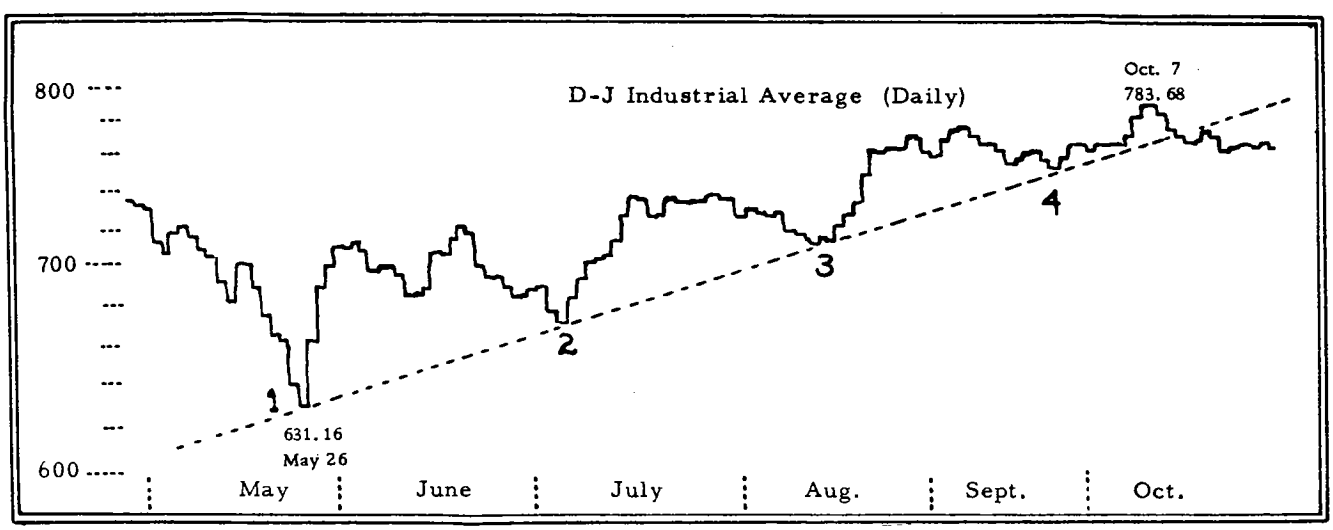
Perhaps most dramatic is the London price of gold which jumped 70¢ to $39.15 on the first fixing, October 26. At $39.15, gold is selling at an 11% premium over the "official" manipulated price of $35 an ounce. And the dollar is beginning to weaken dramatically in terms of gold. As I have been warning, foreigners are beginning to run scared regarding dollar holdings, and those dollars are going into gold. (More on gold later in this Letter).

TRENDLINE: Trendlines play absolutely no part in Dow Theory. According to Dow's Theory, a trend is intact as long as the Industrial and Rail Averages succeed in confirming each other through preceding points. Nevertheless, I do pay attention to trendlines particularly when those trendlines appear on semi-logarithmic or ratio scale charts.

The accompanying chart is simply a blow-up of the page 1 chart for Industrials. The scale used on the chart is semi-log, which means that all movements appear as percentages. In other words, a rise in the Dow from 250 to 500 will appear as exactly the same distance on the chart as a rise from 400 to 800. In both cases, the percentage of rise is the same.

The rise from the May 26 low of 631.16 to the October 7 peak of 783.68 was extraordinary in that the rise held to a very steady percentage of increment. In other words, the rise shows on a semi-log chart as a perfect trendline drawn through four definite points of contact with the trendline. These four points are numbered on the chart. On October 12 the Industrial Average slipped below the trendline, and for the first time on the entire advance the rate of ascent was ruptured.

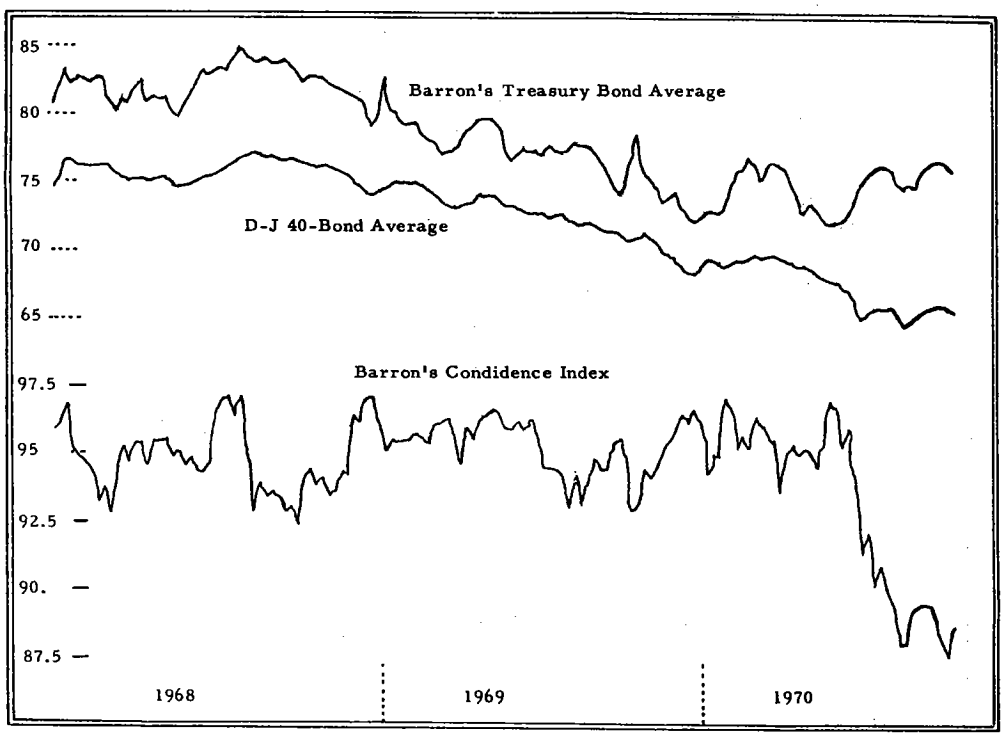
It is very unusual to see such a perfect rate of ascent registered on the chart. As a rule, the more times a trendline is tested, the more important that trendline. The four perfect tests of the May to October trendline suggest to me that the



trendline, even though secondary rather than primary as far as the market is concerned, was an important one. I would therefore guess that the breaking of the trendline on October 12 could spell the beginning of the end for the current secondary rise. A further period of distribution could now occur, but I feel that the next important trendline to be established will be a bearish one.

INVESTOR CONFIDENCE: In the last issue I discussed the adverse implications of the huge 4.9% stock-bond yield spread, a spread which is in favor of the bond buyer over the stock buyer. In this issue I want to cover a little more on the bond picture.

The accompanying chart shows two important segments of the bond market. The top line traces Barron's U. S. Treasury Bond Average going back to 1968. The middle line traces the path of the broad D-J 40-Bond Average. The bottom line covers Barron's Confidence Index. The C.I. is the ratio of the yields on Barron's 10 Highest-grade bonds and the lesser-quality D-J 40-Bond Average.



For purposes of comparison, it is interesting to note that the lesser-quality 40-Bonds (see chart) have, since late-1969, been acting much worse than the relatively high-quality Government bonds. As the spread between high quality bonds and medium-rated bonds increases, the C.I. (which is merely a yield ratio) also declines. Such action signifies that sophisticated investors, the type which buy bonds, are forsaking the fantastically attractive yields on the 40-Bond Average (average yield on the 40-Bonds is now 9.07%) in favor of lower but much safer yields on the highest quality bonds (the average yield on Barron's 10 Highest-grade Bonds is now 7.94%).

The men in the bond market are perhaps the most knowledgeable group in the nation when it comes to money and credit. When they move steadily towards safety, it is usually a sign of impending danger. As a rule, what the bond market knows the stock market finds out about. This provides the oft seen lead time of 2 to 4 months between an important movement in Barron's Confidence Index (i.e., the bond market) and the stock market.

The 1970 peak on the C.I. was 97.1 recorded on the week ending February 2. As late as June 8 the C.I. was giving a reading of 96.9. Then the confidence of bond buyers started deteriorating rapidly. By October 12, 1970, the C.I. had dropped to 88.0. Last week the C.I. broke to a new low of 87.5.

The conclusion, to me, is inescapable. Bonds generally move before stocks. If confidence is now rapidly deteriorating in the bond market, it should only be a matter of time before confidence starts deteriorating in the stock market. In fact, I would say that the collapse in confidence which has hit the debt (bond) sector of the market, driving Barron's C.I. to its lowest level in years, could easily produce new lows in the stock market by the end of the year or the first quarter of 1971.

DIVIDENDS: In Letter 471 I presented the index which I have developed to show the all-important trend of dividends. One of the fascinating things about this study is that the trend of dividends (see page 4 chart) corresponds closely with the primary (as well as strong secondary) trends of the market.

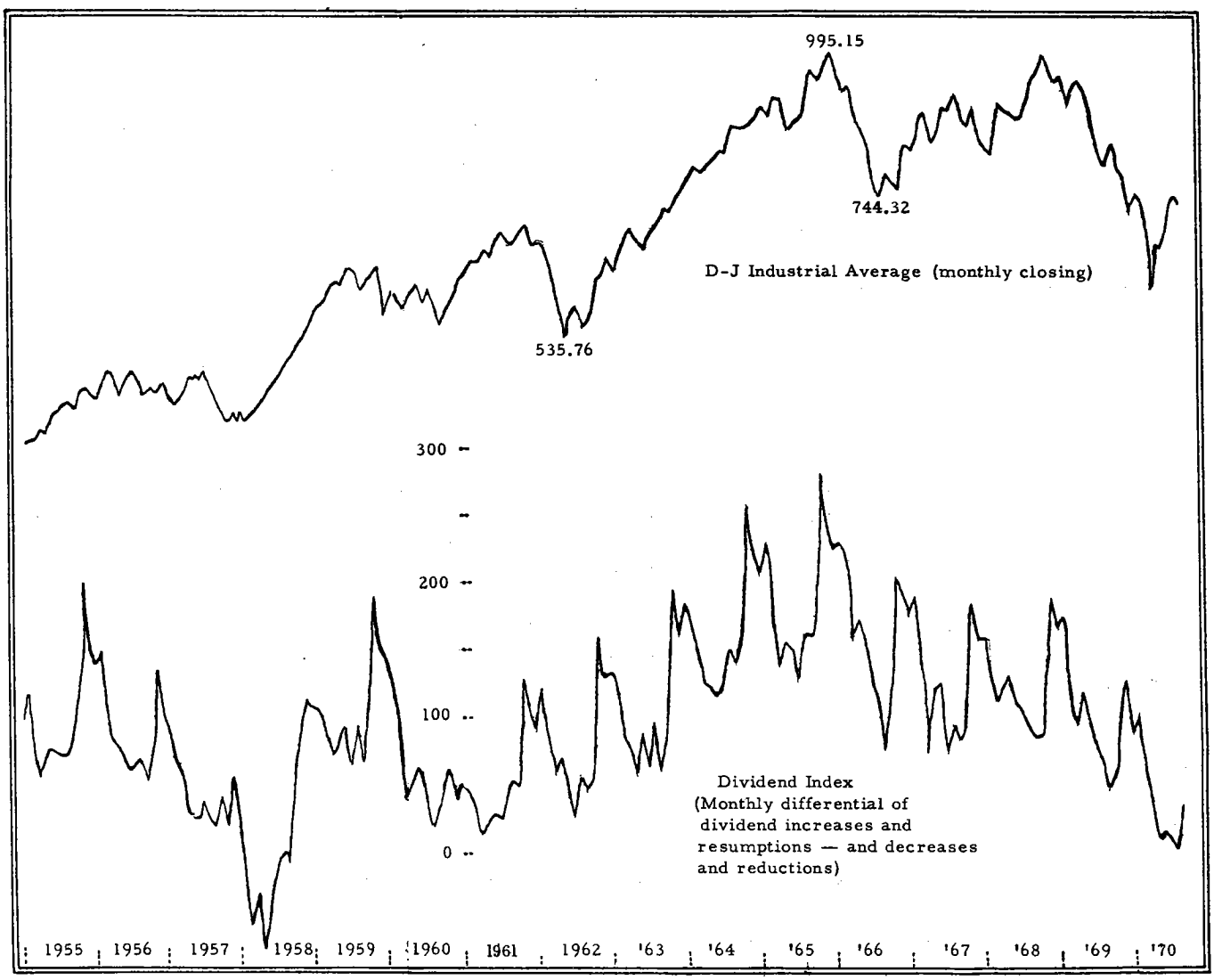
The chart graphs the Standard & Poor tabulations of dividend increases and resumptions minus dividends and omissions each month (tabulations are from 2 to 3 thousand reporting corporations). Note on the chart that following the 1955-58 dividend drop, which was accompanied by a stock market decline and economic recession, the trend of dividends started up again. The trend hit a peak in late-1965, about five months before the bull market top.

Since that time the trend of dividend declarations has been steadily deteriorating. The latest tabulations for September, 1970, show 65 increases and resumptions and 33 decreases and omissions for a final tabulation of plus 32. This compares with a 1969 showing of 74 increases and resumptions and 28 decreases and omissions or a final 1969 tabulation of plus 46 for September.

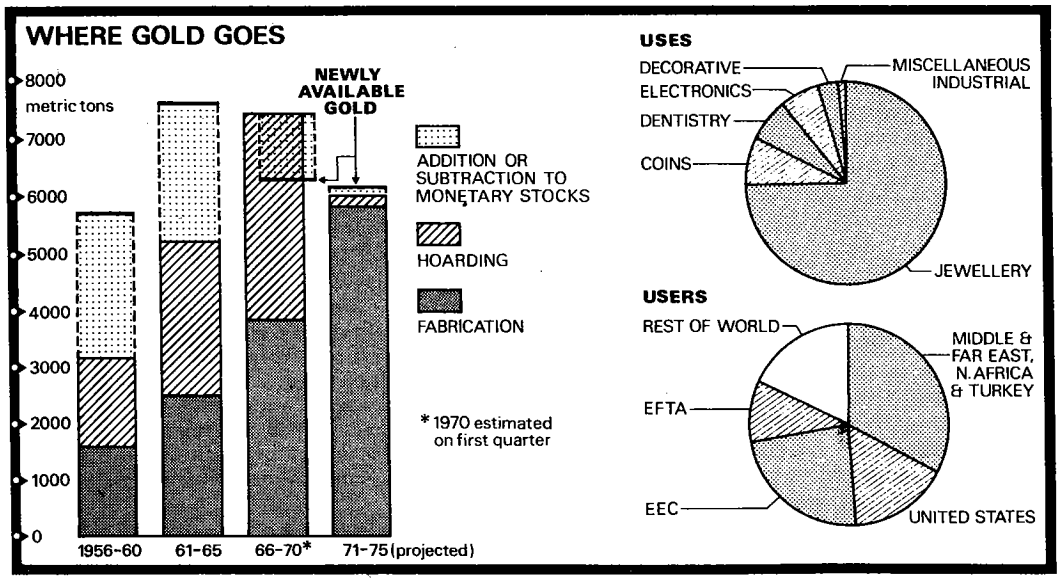
For the three months of July, August and September, 1969, the total tabulation was plus 190. The total tabulations for the same three months of 1970 was plus 47. The three-months total of 47 is the worst for any three months since 1958.

A study of the chart will show that there is usually a strong upward bias on the index sometime during the second half of each year. The only exceptions to this were the years 1957 and 1960. So far, in 1970, the upward bias for the last half of the year has been noticeably absent. It will be interesting to see whether the index continues weak during October, November, and December. My own guess is that during 1971 and 1972 the index will plunge far into minus territory. This will mean that dividends cuts and omissions are far outweighing any tabulation of favorable dividend actions.

As this bear market enters the latter half of the second phase and into the third phase, I expect dismal dividend news to be one of the factors which brings on the kind of stony pessimism which is generally associated with the final throes of a primary bear market. Nothing stirs up greater disillusionment and fear then wholesale dividend cuts among investment-grade and blue-chip stocks. There is a psychology among dyed-in-the-wool investors which causes them to hold on during any and all declines. This kind of thinking is closely connected with the phrase, "It may be down, but it still pays out that



dividend". When the last five words of that phrase have no more meaning, the bear market will be getting well into its third and final phase.



MORE ON GOLD: The October 3 issue of the London Economist included a significant piece on gold together with a chart. The chart tells a most important story in itself, and I have reproduced the chart in this Letter.

The four vertical bars show the amount of newly available gold. The first three bars are from actual IMF figures, the fourth bar is from a forecast by Consolidated Gold Fields. Note that Gold Fields expects the total of newly available gold to decrease during the 1971-75 period (this decrease due mainly to a decrease in annual South African production).

But what is most outstanding is the trend of gold fabrication. During 1956-60 fabrication took up about one-third of total new production. During 1966-70 fabrication took up about half of all new production. With the uses of gold multiplying rapidly in the industrial field, Gold Field expects literally all new gold to go into fabrication during 1971-75. Note that their prediction for hoarding during 1971-75 is very, very conservative. My own bet is that between hoarding and fabrication, there will be no net additions to monetary gold stock during 1970-71 unless the price of gold is raised and whole new sources and mines are put into production. Thus, from the standpoint of new gold production over the foreseeable future, I believe the scramble for gold is now beginning.

The circle marked "uses" is also very interesting. Note that three-quarters of available "fabrication" gold is now used for jewelry. I expect this trend to change somewhat as electronics and miscellaneous industrial uses continue to increase. The fact is that gold has many properties which (in combination) are enjoyed by no other metal. The uses of gold are expanding rapidly in industry and this together with the persistent and increasing use in jewelry should serve to use up all available newly mined gold during the next few years. I might add that as the scarcity of gold becomes more publicized, I expect it to have even more attraction for the public in the jewelry segment of the market. For instance, if a gold bracelet sells for $100, the buyer will say to himself, "I might as well buy it because it's not only pretty but at the present price of gold it's an investment."

I have been recommending the holding of assorted gold shares throughout this primary bear market. Americans are not allowed to hold gold itself or even gold coins minted after 1933. Therefore, the retention of gold shares remain our only hedge against a dollar which is losing its value year after year. Since the dollar is actually defined in terms of gold, it is obvious that as the dollar is worth less and less, it will require increasingly more dollars to purchase an ounce of gold.

The price of gold has been artificially pegged since the early 1930's while the price of almost all other commodities and objects has risen. The longer this artificial process continues, the greater will be the ultimate required price rise in gold. Since a rise in the price of gold can take place without increasing the gold-mining costs of any mine (except for boosts in taxes), it is clear that a gold price rise will greatly enhance the profits of most hold mining entities. This is the attraction of owning shares in legitimate gold mines such as Dome, Campbell, Homestake, Western Deep Levels, President Steyn, President Brand, Blyvoors, Free State Geduld, and many others.

In all, I feel that the gold picture could well be ready to burst upon the markets and economies of the world, if for no other reason than that the uses of gold are multiplying while the monetary need for gold reserves was never greater. Those who have understood and had faith in gold have been weathering a barrage of ignorance and politically-inspired nonsense for the past five years. Sooner or later, the nonsense will give way to truth and reality. The writing is on the wall, and the world is now beginning to read the writing.

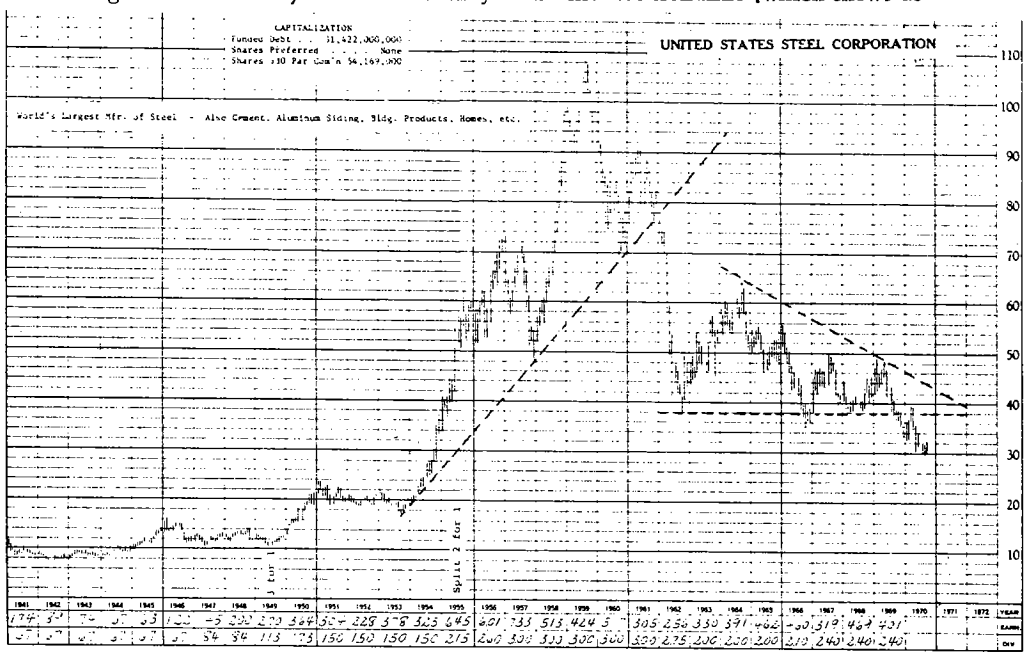
STOCKS: A number of years ago when I was a good deal younger there used to be a Wall Street adage which went, "As steel goes, so goes the market." Of course they were referring to giant U.S. Steel, the world's largest steel producer. I am including two long-term (monthly) charts courtesy of M.C. Horsey, Salisbury, Md., 21801. The first shows U.S. Steel from 1941 to the present. As seen on the chart, Steel was a leader in the bull market during the period of 1949 to 1959. Then something happened. From its high of 108 in 1959, Steel broke to below 70 in 1960. In 1961 Steel rallied to above 90 again, and as you can see it was still holding above its bull market trendline.

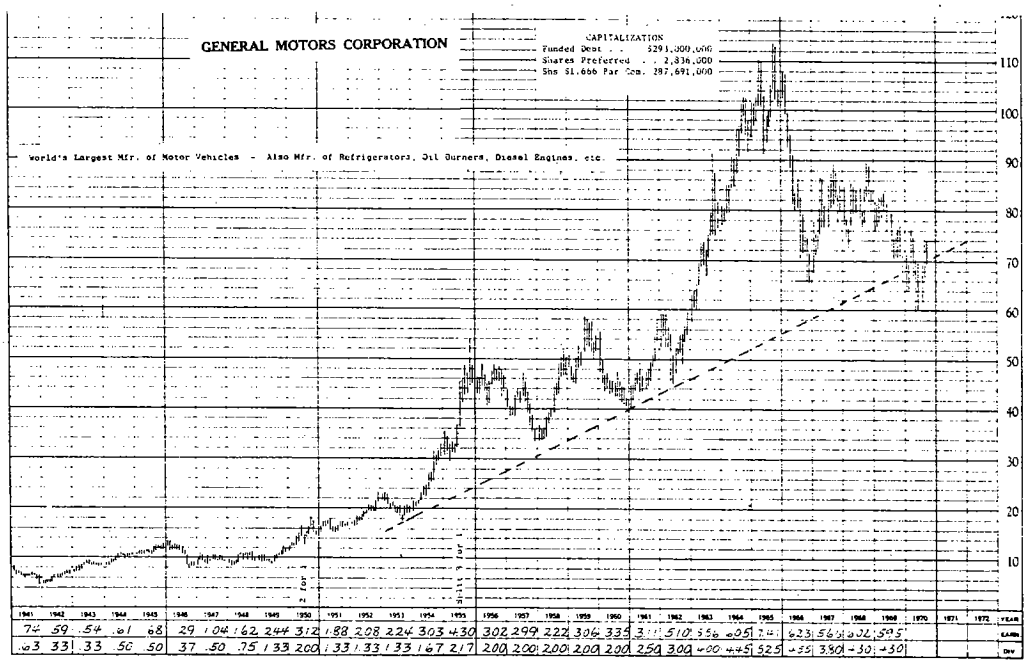
The year 1962 saw Steel crushed by the market. By 1962 Steel had sunk below 40, and the old adage was proved right in a way. For 1962 also saw the entire market go into a tailspin. But from then on, the adage was forgotten. For the market recovered, but Steel never came back. Between 1962 and 1969 Steel traced out a huge descending triangle (see chart) with a base at the 38 area. By late-1969 once-mighty Steel broke ignonimously below the 38 area, and during 1970 it actually shattered the 30 level. Thus one of America's great corporations, the market leader, had lost almost three-quarters of its market value since the high, a feat which still amazes me.

To my mind, General Motors is unquestionably the U.S. Steel of the present. As Motors goes, so goes the market. To me it would be inconceivable to see Motors do what Steel did during the 1960's without throwing the entire market and the economy into a massive collapse.

Turning to the Motors chart, we see that during 1970 GM finally shattered its major bull market trendline (which shows at about 70 at the time of this writing). The recent rally has succeeded in bringing GM above the trendline again, and I believe it will be crucial to note whether GM can hold above its trendline over the period ahead. If not, if GM plunges below the 60 level I would say that the market will not be able to hold up under the pressure.

U.S. Steel collapsed eight years ago and the market recovered without Steel ever really recovering. I don't think the same thing could happen again in the event of a GM collapse. Particularly since such a collapse would be occurring during a primary bear market (unlike the Steel collapse of 1962, which took place during a secondary reaction in a primary bull market).





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